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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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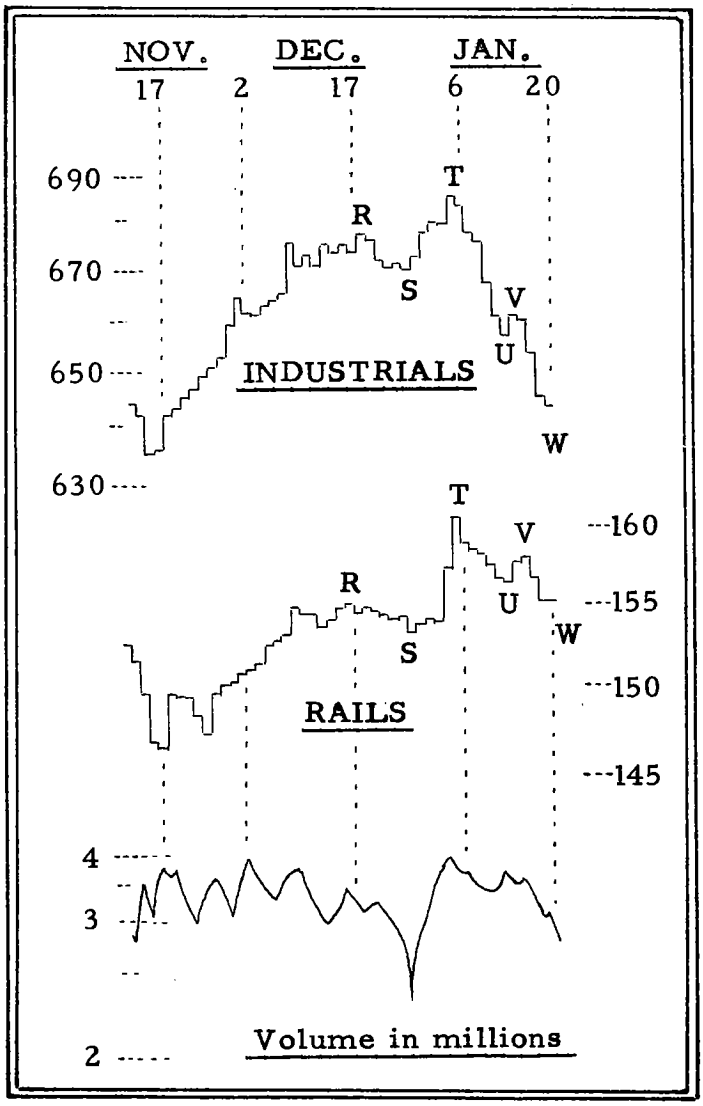
THE MARKET. The ominous aspect of the sell-off since January 5 is the utter complacency which has accompanied it. While the New York Times complained that the break may have been aggravated by "chart reading", most other commentators suggested that the new levels represented a golden opportunity to buy. Personally, I prefer to hear cries of "bear market" when stocks go down, for no bear market ever began when the public thought they saw one coming.

Having violated point S (see chart), Industrials dropped 42 points in a period of eleven days. In so doing, they formed a downward zig-zag (T-U-V-W). I noted in Letter 90 that Rails were reversing their recent role and were showing up as the stronger Average. Further proof of this came on the T-W decline when carriers held their percentage losses to half those suffered by Industrials.

Letter 90 also stated that the most hopeful part of the current market picture was the fact that Rails, by holding above their comparable S point (153.32), had not confirmed the weakness in Industrials. It is worth noting, however, that even though Rails have held above S, they have now formed a minor downward zig-zag (T - U-V-W). A further decline with Rails violating their S point as volume increases would, of course, be bearish and could suggest a testing of the September-November, 1959 lows (Industrials 616.45, Rails 146.65). A breaking of these lows on high volume would signal the bull market's end.



A bullish indication at this juncture would be a rally on increasing volume which would take Industrials above V (660.53) and Rails first above V (157.98) and then above T (160.43). A bettering of both T points would serve to clear the atmosphere for the time being. From the bulls' standpoint, the most hopeful indications at present are (1) volume receding as the T-W decline progresses (2) the remarkable performance by Rails in holding above point S.

Rallies on diminishing volume should not be considered bullish, and they often provide good selling spots for those who are ready to swap stocks for cash. Declines on low or diminishing volume are usually not bearish, but they sometimes prove deceptive. There have been cases where both Averages retreat on low volume until a previous decline point is penetrated -- then volume expands as prices drop sharply.

Subscribers may remember that up to mid-1959 I used to offer opinions as to the next probable direction of the market, whereas I now present the implications of penetrations in either direction. Because of the unsatisfactory technical indications, I now feel that I would be doing readers a disservice by attempting to "out-guess" the price movements. In areas such as this one, it is better to let the Averages tell their own story. Parenthetically, most of the guessing I have heard over the last few months has proved rather costly.

THE TECHNICAL VIEWPOINT. In my opinion, the average investor would show far better results if he could divorce himself from the news of the day and apply his energies to interpreting the "voice" of the Averages. Certainly the largest percentage of my own mistakes have been made when I let some particularly "well-reasoned" editorial or economic analysis override the implications of the price movements. The question then arises, if the Averages discount all news why should a Dow Theorist waste time reading the newspapers at all? My answer is that from a Dow Theory standpoint there are certain times when the Averages go against the prevailing news and opinion, and it is at these times that the movements of the market assume their greatest importance.

For instance, at the bottom of a bear market the news is usually hopeless, and the majority of analysts are only too willing to predict even worse things to come. Yet it is exactly this atmosphere which often identifies a bear market bottom. Dow Theorists are thereby doubly alerted, since any rally in such an area may prove to be the first leg of a new bull market. By the same token, when the forecasts are unanimoualy bullish and when professionals are vieing with each other as to the probable extent of "the next bull swing", any decline in the Averages can assume a peculiar importance. The reason, of course, is that bear markets begin when the newspapers are dotted with "record production" figures and when there are few clouds on the financial horizon.

One of the most useful tenets of Dow's Theory states that a trend is taken to continue until reversed by a valid counter-signal. This principle may seem rather obvious, yet it has proved valuable during troublesome areas in the past. Many veteran Dow Theorists are now retaining long-term commitments solely on the basis of this "continuing trend" principle and they are willing to hold through anything this side of an actual primary bear signal.

Traders face a more difficult problem, however, and it might be well to review the current technical picture for their sakes.

(1) Amid a barrage of optimistic predictions and a settlement of the steel strike, Industrials rose to a new bull market high (January 5 -- 685.47); this high was not confirmed in a primary sense by Rails. The market immediately went into a sharp decline. In most cases where one Average hits a new bull market high the momentum of the penetration carries for at least a few weeks. If the other Average follows "in gear" the indications remain hopeful. Considering the bullish news which accompanied the recent Industrial bull market high (T) and considering the immediate reversal, the action was at best rather suspicious.

(2) The breadth of the market (advance-decline ratio -- see Letter 90) was poor on the recovery from the recent reaction lows, a sign of technical weakness.

(3) The long-term trend of odd-lot transactions appears bearish (Letter 89). Regardless of the normal January reinvestment tendencies, daily odd-lot balances since the first of this year have been heavily on the buy side, never a healthy sign. Odd-lot short sales have held low on the break since T, which suggests that the public is not unduly concerned. In other words, the entire odd-lot picture is weak.

(4) The average yield on the D-J Industrials is now 3.16%. The ratio of stock to bond yields has been unfavorable for over 15 months; it is now -1.6%.

(5) The latest short interest figures show a drop to the lowest total (2.7 million shares) since October, 1957. This brings the short interest ratio down to .82, the lowest point since 1955.

(6) Standard and Poor's Low Priced Stock Index has not bettered its April, 1959 high of 78.62. This index historically tops before the high-grade D-J Industrials. There is at least a reasonable chance that the Low-Priced Stocks have topped.

CONCLUSION. The aforementioned signs of technical deterioration do not make pretty reading; they should put us on our guard. While there are no infallible indicators available to market students (and there never will be), the present situation is suspect. Long-term holders will have to make up their own minds regarding personal courses of action; in the event of a bear signal certainly all common stocks should be abandoned. Traders will find it hard on their bank accounts and nerves to make money in this type of market -- there are times when "they also serve who only stand and wait".

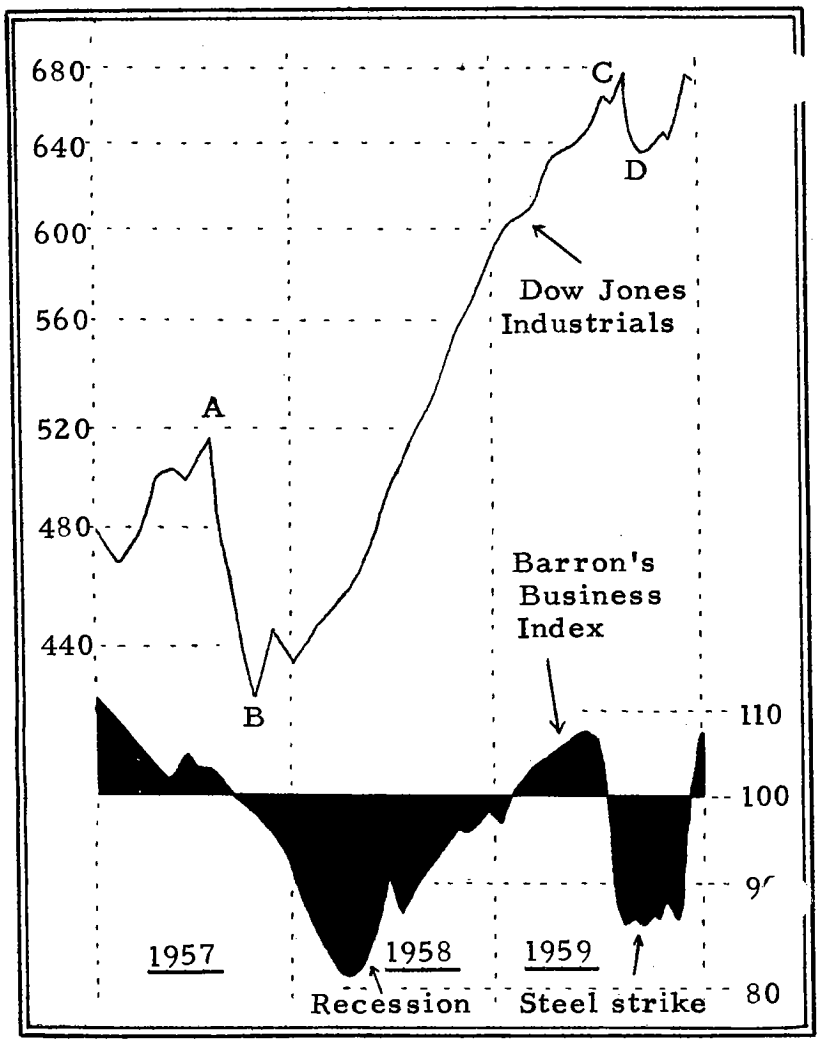
THE AVERAGES PREDICT. Although the majority of subscribers to these Letters are individuals who are concerned with the management of their own portfolios, my subscription lists contain a goodly number of names representing America's leading corporations. Whether or not the treasurers and presidents of these corporations believe in Dow's precepts I do not know, yet their yearly renewals suggest that they follow the Dow Theory with more than passing interest. The great Editor of the Wall Street Journal, William P. Hamilton, once wrote, "There is no business so small that it can afford to disregard the stock market barometer. Certainly there is no business so large that it dare disregard it." Hamilton based all his writing on the premise that the Averages, when properly interpreted, do predict coming events. "Everything that everybody knows about anything with even a remote bearing on finance finds its way into Wall Street, in the form of information" he wrote; "the stock market itself, in its fluctuations, represents a sifted value of all this knowledge."

A few years ago I constructed charts of the Dow Jones Industrial Average together with Barron's Weekly Indexes of Production and Trade (Barron's Business Index) going back to 1897. Being a skeptic, I wanted to put Dow's Theory to the test. I was not long in reaching a conclusion, for even a cursory study of these charts will demonstrate the usefulness of the Averages as a barometer of coming events. I have reproduced a portion of the charts page 4 - that period covering 1957 to the present. I believe this period is worth studying.

Following the double tops made by Industrials in April, 1956 (521.05) and August, 1956 (520.95), the market rallied in 1957 to hit a third top in July (520.77 -- point A on chart). Rails had refused to confirm at either the second or third top, and this, of course, suggested danger. Subsequent to the July, 1957 peak (A), the market went into a severe reaction, hitting bottom in October, 1957 (B). Barron's Business Index had been declining all through 1957, but in the autumn this Index followed the earlier prediction of the Averages, plummeting precipitously to hit a final low in April, 1958. The stock market had touched its low in October, 1957 (B), but despite the deepening business recession that Average turned up. Thus the stock market advance began a full six months ahead of the final bottom established by Barron's Index. The Averages were telling a disbelieving nation that better things were on the way.

The great market advance (B-C) continued to July, 1959, the point where both Averages registered their last confirmed highs. Although Industrials rallied into August (678.10), Rails refused to follow, another hint of danger. Both Averages turned sharply lower in August, despite the universal optimism which prevailed. This reaction (C-D) predicted the biggest steel strike in U.S. history and an accompanying severe drop in Barron's Index. In September Industrials turned up, and two months later Rails grudgingly followed their lead. Barron's Index skyrocketed in early December as production revived following the steel settlement. This takes us to the present.

Although Industrials advanced to a new high on January 5, 1960, the absence of a primary Rail confirmation casts a shadow of doubt over the current picture. As I have stated many times before, the prosperity which we have all been assured is "in the bag" will not be confirmed by the market until Rails better 173.56, their previous high point. A persistent refusal by Rails to better this point should be taken by Dow Theorists as a potential (but not definite) sign of weakness in the price structure.



QUESTION. "I note that you have not mentioned individual stocks lately, why?" (S.R. Vermont)

ANSWER. I generally talk about individual stocks when I am reasonably convinced that they may be purchased to advantage. I have not been reasonably convinced of late.

ANNOUNCEMENT: New York area readers may be interested in a course which I am teaching at the New School for Social Research, 66 West 12th Street, New York 11. The first session begins on February 3rd, 8:30 PM. The course will deal with the technical approach in forecasting market trends as well as individual stock charting. Those interested should write to the New School requesting their Spring, 1960, catalogue. The course is fully described in the catalogue. To my knowledge, no similar course is available anywhere.

NOTE. I wish to thank all those who renewed or extended subscriptions as per the note in Letter 90. Where kind words were added, I extend an extra "thank you"; I am sorry that I could not answer each letter personally.

(Written January 21st - 1:00 P.M.)

Thirty Stocks Used in Dow Jones Industrial Averages are:

Allied Chemical	General Electric	Sears Roebuck
Aluminum Co.	General Foods	Std Oil of Cal.
Amer Can	General Motors	Sr Oil of N. J.
Amer Tel& Tel	Goodyear	Swift & Co.
Am Tobacco	Inter Harvester	Texaco Inc.
Anaconda Co.	Inter Nickel	Union Carbide
Bethlehem Steel	Inter Paper	United Aircraft
Chrysler	Johns Manville	U. S. Steel
Du Pont	Owens-Ill. Glass	Westinghouse El
Eastman Kodak	Procter & Gamble	Woolworth

Twenty Railroad Stocks Used are:

Atchison	Erie	NY NH & H
Atl Coast Line	Great North Ry	Norfolk & West'n
Baltimore & Ohio	Illinois Central	Pennsylvania
Canadian Pacific	Kansas City So	Southern Pacific
Ches & Ohio	Louisv & Nash	Southern Railway
Chi Rk Is & Pac	N. Y. Central	Union Pacific